

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:VWV:RCH:TL-N-962-00
CMDRees

date: FEB 25 2000

to: Chief, Examination Division, Virginia-West Virginia District
Chief, Coordinated Examination Branch
Attn: Tyrone Hicks, Manager, Group 1115

from: CHERYL M.D. REES
Attorney

subject: [REDACTED]
Applicability of I.R.C. § 6662

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

What is the meaning of the terms "frivolous" and "patently improper" items as they are used in regulations relating to the accuracy-related penalty imposed by I.R.C. § 6662.

CONCLUSION

[REDACTED]
, (b)(7)e, (b)(5)(DP)

, (b)(7)e, (b)(5)(DP)

FACTS

The scope of your request for advice is very limited. You are considering asserting the accuracy-related penalty in a case in which losses sustained in a taxable year ending within [REDACTED] are carried forward to another year in which there was an understatement of tax. You have merely asked for our advice as to the meaning of the terms "frivolous" and "patently improper" as they relate to the accuracy-related penalty.

ANALYSIS

In order to provide greater clarity, we will put our discussion of the terms "frivolous" and "patently improper" within a discussion of the entire accuracy-related penalty as it was imposed by I.R.C. § 6662(a) during the 1993 taxable year.¹

In 1993, I.R.C. § 6662(a) and (b)(1) imposed an accuracy-related penalty on any portion of an underpayment of tax required to be shown on a return which was attributable to negligence or the disregard of rules or regulations. The statute defined negligence as, "any failure to make a reasonable attempt to comply with the provisions of this title," and defined disregard as including, "any careless, reckless, or intentional disregard." I.R.C. § 6662(c).

Treasury Regulation § 1.6662-3 provides guidance regarding the term "negligence." It begins with the statutory definition of negligence but expands it to include the failure to exercise ordinary and reasonable care in the preparation of a tax return. It states that negligence also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly and that a position with respect to an item is

¹ The penalty applies to the portion of an underpayment in a year to which a loss, credit or deduction is carried, if the portion is attributable to proscribed conduct in the year in which the carryforward arises. See, Treas. Reg. §§ 1.6662-3(d)(1), 1.6662-4(c), and 1.6662-5(c)(1). Thus, the version of section 6662 that applies herein is the version that was passed in the Omnibus Budget Reconciliation Act of 1989.

attributable to negligence if it lacks a reasonable basis.
Treas. Reg. § 1.6662-3.

The regulation also clarifies the statutory definition of disregard of rules or regulations by noting that such behavior is "careless" if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. Such behavior is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is "intentional" if the taxpayer knows of the rule or regulation he ignores. The regulation also discusses the exception for adequate disclosure. Treas. Reg. § 1.6661-3.

The general, judicial definition of negligence under either I.R.C. § 6662(a) or its predecessor, section 6660, has long been that it is the lack of due care or the failure to do what a reasonable and ordinarily prudent person would do under the circumstances. See, e.g., Neely v. Commissioner, 85 T.C. 934, 947 (1985); Maschmeyer's Nursery, Inc. v. Commissioner, T.C. Memo. 1996-78; Reinhardt v. Commissioner, T.C. Memo. 1993-397.

We have surveyed numerous cases in which the issue of whether a taxpayer was liable for an addition to tax or penalty due to negligence was raised. We observed that, in the majority of cases in which negligence was found, the taxpayer failed to keep adequate records, gave contradictory and vague testimony, failed to cooperate at the time of the examination, or simply gave no argument as to why he was not liable. See, e.g., Barrett v. Commissioner, 79 AFTR 2d 97-1087 (1st Cir. 1997); Hirahara v. Commissioner, T.C. Memo. 1997-16; Sindik v. Commissioner, T.C. Memo. 1996-47; Lanigan v. Commissioner, T.C. Memo. 1996-48; Mohuidin v. Commissioner, T.C. Memo 1996-422.

Even if negligence or intentional disregard of the rules and regulations were found under the version of the penalty that applies herein, however, no penalty was to be imposed for the tax treatment of any item if the position being taken in the return was explicitly disclosed in a Form 8275 or Form 8275-R,² was not frivolous and the taxpayer had adequate books and records and had

² Note that the provisions of Treas. Reg. § 1.6662-4(f)(2), which permit disclosure in accordance with an annual revenue procedure for purposes of the substantial understatement penalty, do not apply for negligence or disregard of rules or regulations. See, Char-Lil Corporation v. Commissioner, T.C. Memo. 1998-457.

substantiated items properly. Treas. Reg. § 1.6662-3(c) (applicable for returns filed after December 31, 1991).³

You have asked for our assistance because the only definition given in the regulations for the word "frivolous" in the context of I.R.C. § 6662 is that a "frivolous" position with respect to an item is one that is "patently improper." Treas. Reg. § 1.6662-3(b)(3). This definition does not provide clear direction on its own.

, (b)(7)e, (b)(5)(DP)

. We were able to find only three cases in which the Court considered the application of the provisions of Treasury Regulation § 1.6662-3(c) in connection with I.R.C. § 6662(a). See, Char-Lil Corporation v. Commissioner, T. C. Memo. 1998-457; Kao, et al. v. Commissioner, T. C. Memo. 1997-323; Estate of Holland, et al. v. Commissioner, T. C. Memo. 1997-302.

In Char-Lil Corporation v. Commissioner, T. C. Memo. 1998-457, the Court cited the House Conference Report that described the change made by Congress in 1993 from the "not patently improper" standard to the "reasonable basis" standard. It noted that the reasonable basis standard was "significantly higher" than the not patently improper standard. See, id., citing H. Conf. Rept. 103-213, at 669, 1993-3 C.B. 393, 547. The Court then went on, however, to hold that the penalty applied because the taxpayer did not properly disclose its position on its returns. Therefore, the Court did not need to discuss whether the taxpayer's failure to report personal holding company tax would have evidenced a frivolous position.

In Kao, et al. v. Commissioner, T. C. Memo. 1997-323, the taxpayers were found to have received unreported taxable income. The Court noted that the taxpayers' testimony regarding the unreported income was "vague, evasive, and otherwise unpersuasive." Furthermore, the Court found that documents submitted by the taxpayers in order to corroborate their testimony were dubious. The Court went on to find that, since the petitioners had offered no plausible explanation of their

³ Because you have only asked for our advice regarding the second prong of this exception, we will not offer details about the adequate disclosure requirement or the adequate books and records requirement.

failure to report significant amounts of income they were liable for an addition to the tax under I.R.C. § 6653(a) for 1988 and for penalties under I.R.C. § 6662(a) for their 1989 through 1991 taxable years. It is interesting to note that, although the Court found that the taxpayers had adequately disclosed that one of them had received \$790,000.00 in 1991, they were liable for the penalty, **not** because their position was frivolous, but because they had failed to produce adequate books and records and to substantiate items properly. The Court did not even discuss whether the position taken by the taxpayers was frivolous or patently improper. Id.

Estate of Holland, et al. v. Commissioner, T. C. Memo. 1997-302 was the only case in which the Court actually found that one of the estate's positions was patently improper. In the Estate of Holland, one of the three co-executors was a tax attorney who had formerly worked for respondent's National Office. The estate tax return was filed on February 25, 1991 and the respondent subsequently issued a notice of deficiency making several adjustments. The Court sustained three of the substantive adjustments. The Court found that, with regard to **each** of the three issues, the positions taken on the return had no support in fact or law. The Court also found that the positions taken were not the result of an honest misunderstanding of fact or law that was reasonable in light of the experience, knowledge, and education of the taxpayer. Thus, the Court found that the petitioner did not act with reasonable cause and in good faith. Nonetheless, the Court only concluded that one of the three adjustments constituted a patently improper item.

Regarding one of those adjustments, the Court imposed the accuracy-related penalty because the executor did not keep adequate books and because the disclosure adjustment could have only applied to ½ of the adjustment. Regarding a second adjustment, the Court imposed the accuracy-related penalty because there was no adequate disclosure of the item on the return. In neither of these situations did the Court mention the frivolous or patently improper standard.

Regarding the third issue, the Court determined that the position was patently improper without elaborating upon the legal precedent on which it relied in reaching that conclusion. The underlying adjustment involved 12 checks the decedent had given to her son to deliver to non-charitable donees. At the time she gave the checks to her son, she had insufficient funds in her account to cover them. The son, intending to arrange a loan to cover the checks once he returned from a Thanksgiving holiday trip, placed the checks in his desk. Unfortunately, before her son returned from his holiday trip, the decedent was killed in a

car accident. The decedent's son, her tax attorney executor, wrote replacement checks from the estate account and delivered them to the 12 payees. The 12 checks written by the decedent were never delivered to the intended donees nor were they cashed. Nonetheless, the estate excluded the value of the 12 checks from the value of the estate in the estate tax return it filed. Id.

The Court noted that the taxpayer's exclusion of these sums was totally without merit. Under applicable state law, the gifts were not completed prior to the decedent's death. The fact that the executors issued new checks indicated that they were aware that the original checks were not negotiable. This left the taxpayer with the argument that incomplete gifts were excludable from the value of the estate, a position that the Court found patently improper. Id.

As an alternative position, the estate argued that the value of the checks were a deduction of the estate as a claim against the estate. The Court noted that the estate had not listed the 12 checks on the schedule to the return provided for listing debts of the estate. The Court also noted that, in order to find that the estate's argument that the checks constituted a claim against the estate was not patently improper, it would have to give credence to the estate's argument that a promise to make a gift to one's children based on love and affection is a bargained-for exchange supported by adequate and full consideration in money or money's worth. Id.

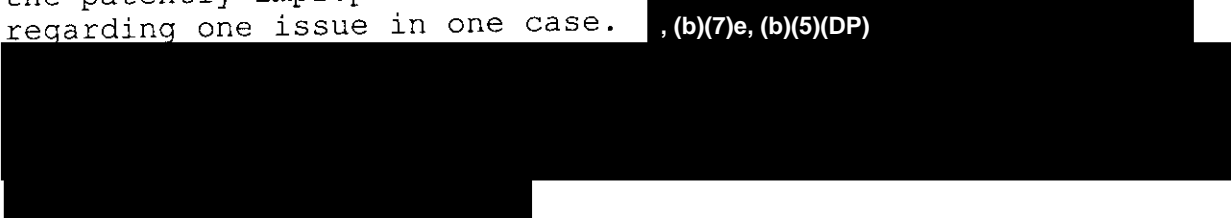
In the preamble to Treasury Decision 8533, 1994-1 C.B. 307, 307, the Secretary provided another source of information regarding the frivolous/patently improper standard when he stated that the "not frivolous" standard that applies to the accuracy-related penalty is the same as the not frivolous standard that applies to return preparers under I.R.C. § 6694. Unfortunately, the regulations promulgated under that section echo the definition set forth in Treasury Regulation § 1.6662-3(b)(3) and cases interpreting I.R.C. § 6694 were not illuminating.

In 1993, even if a taxpayer were found liable under the provisions of I.R.C. § 6662, I.R.C. § 6664(c) provided a reasonable cause exception to imposition of the penalties imposed by I.R.C. § 6662(a). The provision provided that a penalty shall not be imposed if there was a reasonable cause for the understatement and the taxpayer acted in good faith with respect to that understatement. Treasury Regulation § 1.6664-4(b), sets forth rules for determining whether the exception applies to cases such as this. The section states, in part:

The determination of whether a taxpayer acted with


reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. The most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer.

It is clear that we are left with only the advice from legislative history pertaining to a subsequently-passed statute⁴ that the reasonable basis standard is **significantly higher** than the patently improper standard and the Tax Court's finding regarding one issue in one case. , (b)(7)e, (b)(5)(DP)



RECOMMENDATION

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Please remember that we are forwarding a copy of this advice to the Assistant Regional Counsel (Tax Litigation) (CC:SER) and to the Office of Assistant Chief Counsel (Field Service) (CC:DOM:FS) for mandatory 10-day post review. To assure that the National Office has had sufficient time to review our advice, we request that you refrain from taking any action with respect to assertion

⁴ Subsequent legislative history is not a generally accepted source of support for legal arguments.

of the accuracy-related penalty under I.R.C. § 6662(a) prior to March 10, 2000. Please feel free to contact me at (804) 771-2885 with any additional questions you may have.

/s/ Cheryl M.D. Rees

CHERYL M.D. REES
Attorney

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